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IN THE SUPREME COURT OF THE STATE OF DELAWARE

VERITION PARTNERS MASTER FUND LTD. and VERITION MULTI-STRATEGY MASTER FUND LTD.,	)	
Petitioners-Below, Appellants	)	
	)	No. 368,2018
v.	)	
	)	Court below: Court of Chancery
ARUBA NETWORKS, INC.,	)	C.A. No. 11448-VCL
Respondent-Below, Appellee	)	

CORRECTED BRIEF OF PROFESSORS WILLIAM J. CARNEY AND KEITH SHARFMAN AS *AMICI CURIAE* IN SUPPORT OF APPELLEE AND AFFIRMANCE

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TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

INTERESTS OF AMICI CURIAE 1

SUMMARY OF ARGUMENT 2

ARGUMENT 4

I. MARKET PRICES REFLECT FAIR VALUE. 4

A. The Efficient Capital Market Hypothesis demonstrates the fairness and accuracy of market prices. 4

B. Markets are wiser than "experts." 7

C. Pre-announcement market prices presumptively reflect fair value irrespective of nonpublic information. 9

D. The pre-announcement market price does not reflect an implied minority discount. 11

II. DELAWARE STOCKHOLDERS ARE HARMED BY APPRAISAL AWARDS IN EXCESS OF THE PRE-ANNOUNCEMENT MARKET PRICE. 16

CONCLUSION 20

RLF1 20256216v.3

TABLE OF AUTHORITIES

Page(s)

CASES

Basic Inc. v. Levinson,
108 S. Ct. 978 (1988)....................7

Borruso v. Commc'ns Telesystems Int'l,
753 A.2d 451 (Del. Ch. 1999)....................14

Cede & Co v. JRC Acquisition Corp.,
2004 WL 5366085 (Del. Ch. Feb. 10, 2004)....................4

Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd,
177 A.3d 1 (Del. 2017)....................4, 5, 6

DFC Glob. Corp. v. Muirfield Value P'rs, L.P.,
172 A.3d 346 (Del. 2017)....................4, 5, 8

Kleinwort Benson Ltd. v. Silgan Corp.,
1995 WL 376911 (Del. Ch. June 15, 1995)....................13

Olson v. ev3, Inc.,
2011 WL 704409 (Del. Ch. Feb. 21, 2011)....................13

ONTI, Inc. v. Integra Bank,
751 A.2d 904 (Del. Ch. 1999)....................13

Verition P'rs Master Fund Ltd. v. Aruba Networks, Inc.,
2018 WL 2315943 (Del. Ch. May 21, 2018)....................11

STATUTES & RULES

8 *Del. C.* § 262(h)....................14

OTHER AUTHORITIES

A. Kaul et al, *Demand Curves for Stocks Do Slope Down: New Evidence from an Index Weights Adjustment*, 52 J. FIN. 893 (2000)....................18

Andrei Shleifer, *Do Demand Curves for Stocks Slope Down*, 41 J. FIN. 579 (1986)....................17

Brad M. Barber & Terrance Odean, *The Courage of Misguided Convictions: The Behavior of Individual Investors* (2011) 9

Burton G. Malkiel, *Are Markets Efficient? – Yes, Even if They Make Errors*, WALL ST. J., Dec. 28, 2000, https://www.wsj.com/articles/SB977962553540358908 9

Eugene F. Fama, *Market Efficiency, Long-term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283 (1998)..5

Eugene F. Fama, *Two Pillars of Asset Pricing*, 104 AM. ECON. REV. 1467 (2014)..5

Eugene F. Fama & Kenneth R. French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 1915 (2010) 9

Hailing Chen et al, *Wisdom of Crowds: The Value of Stock Opinions Transmitted Through Social Media*, 27 REV. FIN. STUD. 1367 (2014)..8

JAMES SUROWIECKI, THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES AND NATIONS (2004).....................................8

Kenneth R. Ahern, *Bargaining Power and Industry Dependence in* Mergers, 103 J. FIN. ECON. 530 (2012) 14

Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. PA. L. REV. 1 (2007)..12, 14, 16

Michael Jensen, *The Takeover Controversy: Analysis and Evidence*, 4 MIDLAND J. CORP. FIN., no. 2, Summer 1986 5

Peter R. Locke & Steven Mann, *Professional Trader Discipline and Trade Disposition*, 76 J. FIN. ECON. 401 (2005)..9

RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE (9th ed. 2008) 8

RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (9th ed. 2014).......................17

RLF1 20256216v.3

Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551 (1998) 9

Richard A. Posner, *Rational Choice, Behavioral Law and Economics: A Critique*, 42 ECON. EDUC. BULL., no. 8, Aug. 2002 (Am. Inst. for Econ. Research) 9

Vincent Glode, *Why Mutual Funds "Underperform,"* 99 J. FIN. ECON. 546 (2011) 7

William J. Carney & Keith Sharfman, *The Death of Appraisal Arbitrage: Ending Windfalls for Deal Dissenters*, 43 DEL. CORP. L. __ (forthcoming, 2018) 1, 8, 13

INTERESTS OF *AMICI CURIAE*

Professors William J Carney and Keith Sharfman ("*Amici*") are law professors who study and teach in the areas of corporation law, corporate finance, mergers and acquisitions, and valuation.[1] They have commented upon appraisal litigation in Delaware courts and their work on valuation is often cited as authority by commentators, litigants, and courts. *Amici* have also taught courses concerning appraisal litigation and legal valuation. They have no financial interest in this case.

This appeal raises, *inter alia*, the question of whether, in appraisal litigation, the Court of Chancery should rely on the valuation of a company's shares provided by an active, deep, fully informed and semi-strong efficient market, or instead defer to the opinions of experts on the value of a company excluding the anticipated or realized effects of the merger. This question falls within the expertise and scholarly interests of *Amici*, who offer their academic perspective and experience to aid in the Court's evaluation of the issues on appeal.

Amici recently published an article praising Vice Chancellor Laster's opinion in this case.[2] We will not repeat the substance of that article here.

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[1] Professor Carney is the Charles Howard Candler Professor Emeritus at Emory University School of Law, and Professor Sharfman is Professor of Law & Director of Bankruptcy Studies at St. John's University School of Law.

[2] William J. Carney & Keith Sharfman, *The Death of Appraisal Arbitrage: Ending Windfalls for Deal Dissenters*, 43 DEL. J. CORP. L. __ (forthcoming, 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3271913.

SUMMARY OF ARGUMENT

The most appropriate measure of fair value in appraisal litigation is market valuation and not expert driven post-merger analyses. In a semi-strong efficient market, the stockholders of public companies are protected from unfair deals by receiving as fair value for their shares what they would have received if they had sold their shares in an arm's length transaction before the market price was affected by the announcement of a merger. Experts who attempt to value a publicly traded company's stock are handicapped by having to make assumptions that differ from the market's consensus and often by having to calculate and remove synergies from the initial estimate of the firm's value. In the absence of specific evidence of conflicts or fraud affecting the market price, market price is superior to expert valuations as a measure of fair value and is equivalent to the fair value of a stockholder's shares.

Appellants/Petitioners-below ("Petitioners") and the *amici curiae* professors supporting them defend replacing a market valuation with a post-merger discounted cash flow ("DCF"), in effect asserting the superiority of the analysis of experts over the market.[3] This argument flies in the face of the well-established and accepted Efficient Capital Markets Hypothesis ("ECMH") and requires this

[3] *See* Corrected Brief of Amici Curiae Professors Audra Boone, Brian Broughman, Albert Choi, Jesse Fried, Mira Ganor, Antonio Macias, and Noah Stoffman in Support of Appellant and Reversal filed on October 3, 2018 (the "Amici Opening Brief").

Court to endorse questionable theories regarding implicit minority discounts. It also ignores the real-world evidence that even expert investors in mutual and other financial funds underperform the relevant market index. Furthermore, Petitioners simultaneously take contradictory positions in arguing that financial expert valuations are superior to market values, but that behavioral economics suggests that sophisticated market players or "experts" (including the institutions that currently dominate investment markets) are poorly informed actors that make unreliable price judgments. Thus, market prices and not experts provide the best evidence of fair value in appraisal litigation.

ARGUMENT

I. MARKET PRICES REFLECT FAIR VALUE.

A. The Efficient Capital Market Hypothesis demonstrates the fairness and accuracy of market prices.

In the absence of fraud or conflicts that provide substantial reason to doubt the fairness of the market price, the Court of Chancery should defer to the pre-announcement market price of a publicly traded stock to determine the fair value of a dissenter's shares. The general accuracy and fairness of market pricing is already well established in Delaware as a matter of law.[4] That Delaware has accepted the ECMH cannot be seriously disputed. This Court has recognized, most recently in its decisions last year in *DFC* and *Dell*, the important informational and price determination functions that deep and efficient trading markets perform.[5] It is

[4] *See, e.g.*, *DFC Glob. Corp. v. Muirfield Value P'rs, L.P.*, 172 A.3d 346, 369–70 (Del. 2017) ("Market prices are typically viewed superior to other valuation techniques because, unlike, e.g., a single person's discounted cash flow model, the market price should distill the collective judgment of the many based on all the publicly available information about a given company and the value of its shares."); *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd*, 177 A.3d 1, 24 (Del. 2017).

[5] *Cede & Co v. JRC Acquisition Corp.*, 2004 WL 5366085, at *3 n.28 (Del. Ch. Feb. 10, 2004); *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund, Ltd.*, 177 A.3d 1 (Del. 2017); *DFC Glob. Corp. v. Muirfield Value P'rs, L.P.*, 172 A.3d 346 (Del. 2017).

therefore unnecessary to recite here all of the evidence in support of one of the most celebrated propositions in all of the social sciences.[6]

The ECMH posits that publicly traded stocks are priced accurately and efficiently, at least in the "weak" or "semi-strong" sense of fully reflecting all public information about the stock.[7] The semi-strong form of ECMH has generally been accepted by economists and this Court.[8] The widely accepted semi-strong form asserts that as new information about a publicly traded stock becomes publicly available, this information is rapidly reflected in stock prices. By contrast, the strong form, which asserts that all information, public or not, is impounded in stock prices, has largely been rejected.[9]

In *DFC* and *Dell*, this Court noted the widespread acceptance (and evidence in support) of this learning.[10] In *Dell*, this Court commented on the relative value of market prices versus expert opinions, stating:

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[6] Michael Jensen, *The Takeover Controversy: Analysis and Evidence*, 4 MIDLAND J. CORP. FIN., no. 2, Summer 1986, at 6, 11; *see also* Eugene F. Fama, *Two Pillars of Asset Pricing*, 104 AM. ECON. REV. 1467 (2014) (Nobel lecture summarizing the ECMH literature and the theory's widespread acceptance).

[7] Fama, 104 AM. ECON. REV. at 1467-69; *see also* Eugene F. Fama, *Market Efficiency, Long-term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283 (1998).

[8] *Dell*, 177 A.3d at 24 (noting that the "efficient market hypothesis" has "long [been] endorsed by this Court").

[9] Amici Opening Brief at 4 (conceding this point).

[10] *DFC*, 172 A.3d at 367; *Dell*, 177 A.3d at 23-24 (criticizing the trial court's disregard of market prices and the efficient market hypothesis, which led to

> [T]he Court of Chancery's analysis ignored the efficient market hypothesis long endorsed by this Court. It teaches that the price produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client.[11]

The Amici Opening Brief argues that a market price not fully reflecting nonpublic information is "a poor substitute for more reliable valuation evidence such as a discounted cash flow analysis."[12] But the Amici Opening Brief provides no reason to suppose that, in the absence of conflicts or fraud proven to impact the market price, a DCF analysis commissioned by a self-interested litigant should ever be a more reliable indicator of fair value than an unbiased, public market price that is untainted by fraud or conflict. It is possible that evidence of conflicts or fraud by target management could rebut the accuracy of the pre-announcement market price. In the absence of such a showing, however, the pre-announcement market price is the most reliable evidence of fair value, as it impounds and reflects both the aggregate information of market participants and all of the upside and downside risks associated with future disclosures of currently non-existent or nonpublic information.

Petitioners also argue that ECMH "relates to informational efficiency, not

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the erroneous conclusion that the bidding over Dell led to a deal price that was below fair value).

[11] *Dell*, 177 A.3d at 24.

[12] Amici Opening Brief at 7.

fundamental efficiency, and does not claim that a company's stock price reflects fundamental value."[13] This argument misunderstands the nature of market pricing. In his concurring opinion in *Basic Inc. v. Levinson*, Justice White explained:

> To define the term "integrity of the market price," the majority quotes approvingly from cases which suggest that investors are entitled to "'rely on the price of a stock as a reflection of its value.'" But the meaning of this phrase eludes me, for it implicitly suggests that stocks have some "true value" that is measurable by a standard other than their market price.[14]

In other words, there is no such thing as a "true" or "fundamental" value that differs from a stock's market price.

B. Markets are wiser than "experts."

The superior wisdom of markets relative to experts is readily apparent. Most mutual funds, which employ professional investors who attempt to select the most promising stocks, underperform the relevant benchmark market average, and thus they also underperform index funds.[15] This phenomenon should give rise to a healthy respect for the wisdom of crowds. As a leading corporate finance textbook puts it, "[i]n an efficient market you can trust prices, for they impound all available

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[13] Appellants cite Daniel Fischel, *Efficient Capital Markets, the Crash and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 910-11 (1989) for the phrase "fundamentally efficient market," a phrase that nowhere appears in that article.

[14] *Basic Inc. v. Levinson*, 108 S. Ct. 978, 993, 996 (1988) (internal citation omitted).

[15] Vincent Glode, *Why Mutual Funds "Underperform*,*"* 99 J. FIN. ECON. 546 (2011).

information about the value of each security."[16] Or to state the same principle even more succinctly: "For many purposes no formal theory of value is needed. We can take the market's word for it."[17]

An expert's estimate of a firm's future cash flows is simply an effort by a single person to predict the future. Such an estimate of cash flows is especially questionable in appraisal litigation, where all the perils of bias and inaccurate assumptions presented by competing experts are ever present. Thus, it comes as no surprise that appraisal experts are substantially less accurate than markets at estimating firm values.[18]

More dramatically, the estimates of crowds can be accurate even when information is limited.[19] Market pricing in the aggregate reflects more information about value than any individual can possess. This is true for many markets, including stocks.[20]

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[16] RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 373 (9th ed. 2008); *see also DFC*, 172 A.3d at 370.

[17] BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE at 13; *see also DFC*, 172 A.3d at 370.

[18] *See* Carney & Sharfman, 43 DEL. J. CORP. L. at 110 (Appendix A).

[19] JAMES SUROWIECKI, THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES AND NATIONS, xx-xxi (2004).

[20] Hailing Chen et al, *Wisdom of Crowds: The Value of Stock Opinions Transmitted Through Social Media*, 27 REV. FIN. STUD. 1367 (2014).

Petitioners cite the claims of behavioral economists that markets are systematically inefficient.[21] The theories of those behavioral economists are vigorously contested by distinguished economists not cited by Petitioners.[22] Petitioners also argue that the "efficient market paradox" implies sufficient mispricing of stocks to provide incentives to discover these errors and trade on them.[23] However, the inability of professional traders to consistently beat market indexes substantially undermines this claim.[24] Indeed, even behavioral economists admit that individual investors substantially underperform markets.[25]

C. Pre-announcement market prices presumptively reflect fair value irrespective of nonpublic information.

The fact that market prices do not fully reflect nonpublic information does not create an inference of systematic downward bias, as long as there is no evidence that fraud or conduct intended to mislead the market affected the market

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[21] Appellants' Opening Brief at 27.

[22] Burton G. Malkiel, *Are Markets Efficient? – Yes, Even if They Make Errors*, WALL ST. J., Dec. 28, 2000, https://www.wsj.com/articles/SB977962553540358908; Richard A. Posner, *Behavioral Law and Economics: A Critique*, 42 ECON. EDUC. BULL., no. 8, Aug. 2002 (Am. Inst. for Econ. Research); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551 (1998).

[23] Appellants' Opening Brief at 28-29.

[24] Eugene F. Fama & Kenneth R. French, *Luck Versus Skill in the Cross-Section of Mutual Fund Returns*, 65 J. FIN. 1915 (2010); Peter R. Locke & Steven Mann, *Professional Trader Discipline and Trade Disposition*, 76 J. FIN. ECON. 401 (2005).

[25] *See* Brad M. Barber & Terrance Odean, *The Courage of Misguided Convictions: The Behavior of Individual Investors* (2011), available at http://ssrn.com/abstract=1872211.

price. The Amici Opening Brief incorrectly argues that "the trading price of Aruba's stock prior to announcement can be expected to systematically understate fair value" because deal planners have access to nonpublic information.[26] The professors reason that this deal-related nonpublic information allows deal planners to "more accurately … price [a target's] equity … than outsiders trading in the market" and "there are strategic reasons for keeping such information private until after a signed merger agreement is announced." This leads to the Amici Opening Brief's conclusion that Aruba's "pre-announcement trading price was downward biased."[27]

That argument is illogical. For one thing, nonpublic information could just as easily be negative as positive. There is no reason to suppose that there would be a systematic downward bias in pre-announcement market prices relative to hypothetical market prices fully reflecting nonpublic information. Moreover, the pre-announcement market price already includes the market's assessment of risks associated with nonpublic information. In the absence of conflicts or fraud by the target firm's management that is substantial enough to negatively impact the market value, any nonpublic information provided to the buyer in the deal process should not impact the Court of Chancery's analysis.

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[26] Amici Opening Brief at 4-6.
[27] Amici Opening Brief at 6.

Amici Opening Brief admits that "market prices reflect information that is publicly available at the time."[28] It further claims that the market price as of the date of the merger announcement does not necessarily reflect the firm's value on the closing date.[29] It fails to explain, however, how the Court could infer that any price other than the pre-announcement trading price represents the "fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation." The Court of Chancery must analyze whether the Petitioner has presented any compelling rationale (such as fraud) to justify why the unaffected market price should be adjusted in an upward manner.[30] Unless the Court is provided with such a compelling rationale, there is no reasoned basis to award as fair value anything other than the pre-announcement market price.

D. The pre-announcement market price does not reflect an implied minority discount.

The Amici Opening Brief also argues that market prices reflect an implied minority discount because (1) the market trading price is set by "marginal"

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[28] Amici Opening Brief at 4.

[29] Amici Opening Brief at 2.

[30] *Verition P'rs Master Fund Ltd. v. Aruba Networks, Inc.*, 2018 WL 2315943, at *7 (Del. Ch. May 21, 2018).

investors, and (2) target stockholders have different reserve prices for selling their stock.[31] This theory is not correct

First, there is scant evidence of control premiums—and thus implied minority discounts—existing for publicly traded stocks, especially when there is not a controlling stockholder.[32] Therefore, when (as here) a firm lacks a controlling stockholder, there is essentially no empirical basis finding support in the financial literature for adjusting the price of a stock to account for a supposed minority discount.[33] Moreover, even in cases where a minority discount can be found, there is no basis for minority stockholders who lack control to share in a control premium as part of a fair valuation of *their* shares. To the extent that any minority discount is reflected in a share's market price at the time of sale, such a discount would also have been present when the share was purchased. Thus, an appraisal award granting an upward adjustment on account of a supposed minority discount offers dissenting stockholders not fair value but rather a windfall in excess of fair value.

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[31] Amici Opening Brief at 7-10.

[32] Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. PA. L. REV. 1, 5 (2007) ("not a single piece of financial or empirical scholarship affirms the core premise of the IMD--that public company shares systematically trade at a substantial discount to the net present value of the corporation").

[33] *Id*. at 56.

Similarly, one reason expert valuations of companies are often unreliable is the significant evidence of problems relating to control premia.[34] Beyond the issues of bias and inaccurate assumptions, individual experts are inaccurate in stock valuation because of a tendency to include control premia in their estimates of a target company's value. But absent the potential for an acquisition that will be profitable for a buyer, there is no inherent "control premium" present in any company. Such a premium only arises from the anticipation or realization of an acquisition.[35] Thus, any apparent benefit of working backwards from a deal price to separate the value of synergies from a control premium is illusory.

This was initially recognized in Delaware when, in *Kleinwort Benson Ltd. v. Silgan Corp.*, Chancellor Chandler correctly declined to employ a control premium "because it reflects value arising from the accomplishment or expectation of the merger."[36] As he later explained, the court "will not specifically consider studies of control premiums paid in merger transactions because those reflect expected future profits after the merger (i.e., synergy values)."[37] Yet, in another case, the Court of Chancery applied a 30% control premium to eliminate an erroneously presumed minority discount while conceding "there remains some uncertainty"

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[34] Carney & Sharfman, 43 DEL. J. CORP. L. at 100 (Appendix A).

[35] *Id.* at 93-103.

[36] 1995 WL 376911, at *3 (Del. Ch. June 15, 1995); *see also Olson v. ev3*, 2011 WL 704409, at *10 (Del. Ch. Feb. 21, 2011).

[37] *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 913 (Del. Ch. 1999).

regarding the amount of impermissible post-merger synergies reflected in control premiums.[38] We respectfully submit that the court should have recognized that any premium paid is based on an expectation of benefits to the buyer from the transaction.[39] As a result, any control premium should have been excluded as an "element of value arising from the accomplishment or expectation of the merger."[40]

Second, the Amici Opening Brief argues that "[t]o secure stockholder approval, an acquirer must, at a minimum, pay the price demanded by the median target shareholder" whereas "[t]he market trading price … reflects the valuation demanded by the lowest valuing (i.e., marginal) stockholder."[41] In justifying a premium relative to the pre-deal market price, the Amici Opening Brief conflates an *opinion* as to future value on the one hand, with actual market or fair value on the other. For while it may be true that holders of a stock can diverge in their opinions as to the stock's future market value, the value of the stock as of a particular date remains the price that they can obtain for that stock in the market as

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[38] *Borruso v. Commc'ns Telesystems Int'l*, 753 A.2d 451, 459 n.12 (Del. Ch. 1999).

[39] Kenneth R. Ahern, *Bargaining Power and Industry Dependence in Mergers*, 103 J. FIN. ECON. 530, 547 (2012) (showing that targets capture on average "modestly more" of the merger gains than buyers); Hamermesh & Wachter, 156 U. PA. L. REV. at 30 ("In an arm's-length transaction, an acquirer will pay a premium to [the equity value] in purchasing the firm.").

[40] 8 *Del. C.* § 262(h).

[41] Amici Opening Brief at 9.

of that date.[42] Optimism by one market participant about a stock's future price no more changes its value than does an owner's optimism about the future price of her house change the house's current value.

[42] *See* I(A), *supra*.

II. DELAWARE STOCKHOLDERS ARE HARMED BY APPRAISAL AWARDS IN EXCESS OF THE PRE-ANNOUNCEMENT MARKET PRICE.

The Amici Opening Brief argues that "deferring to the pre-announcement market price would render the appraisal remedy a nullity since in most cases it inherently understates fair value because it is based on minority trades."[43] That is not so. As discussed above, there is no evidence that a minority discount exists in most cases, especially when as here there is not a controlling stockholder.[44] So the pre-announcement price does not understate fair value in the vast majority of cases. Awarding the market price, however, hardly renders the appraisal remedy a "nullity."

Utilizing the pre-announcement market price still leaves room for the appraisal remedy to have a benefiical effect in the most concerning cases. The appraisal remedy remains valuable when there are conflicts or fraud that actually impacted the market price, such as evidence showing that the target firm's management manipulated its stock price downward so as to give the buyer a better deal. In these limited situations, where the pre-announcement market price was demonstrably tainted by wrongdoing, the appraisal remedy provides additional protections for stockholders to receive a fair value award in excess of the pre-announcement market price.

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[43] Amici Opening Brief at 2.

[44] Argument I(D), *supra*; Hamermesh & Wachter, 156 U. Pa. L. Rev. at 5-6.

Moreover, the Amici Opening Brief argues that "[r]ecent empirical scholarship demonstrates that Delaware stockholders … would be harmed if appraisal valuations collapse down to a target's pre-announcement market price."[45] This argument depends, however, on a factual proposition that the cited literature never demonstrates: that setting the appraisal price in excess of the pre-announcement market price would not adversely affect deal flow.[46] While the cited studies do not present "evidence that appraisal arbitrage is causing Delaware to lose deal-flow or causing deal planners to avoid doing cash deals," the cited studies also do not present any evidence that deal flow is *not* adversely affected by appraisal arbitrage.[47] Put simply, the Amici Opening Brief cites only speculation, but no empirical evidence showing the impact that appraisal awards in excess of the pre-announcement market price have on deal flow.

The Amici Opening Brief and the studies that it cites speculate that "bidders protect themselves against threat of appraisal … by increasing their upfront bid."[48] In fact, however, basic economic theory dictates that when deal prices go up, deal volume must necessarily go down.[49] While it is possible that some buyers would

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[45] Amici Opening Brief at 2.

[46] *See* Amici Opening Brief at 11.

[47] *See* Amici Opening Brief at 11

[48] Amici Opening Brief at 13.

[49] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 5 (9th ed. 2014) "The Law of Demand posits an inverse relation between price charged and quantity demanded."); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down*?, 41 J.

pay more for acquisitions if the appraisal remedy were more robust, it is at least as likely that other buyers would be priced out of the market and walk away from deals that they would have made if there were a less robust appraisal remedy. Thus, the net effect for stockholders of an above market appraisal remedy might well be negative, and it would undoubtedly be negative for at least some stockholders. In short, the Amici Opening Brief ignores that while a robust, discretionary appraisal remedy could perhaps lead to higher deal prices in some cases—prices above the fair value of the firm's stock—it also would decrease the number of arm's length public company sales that would otherwise be consummated.

Finally, notwithstanding the lack of theoretical foundation and empirical support for the claim that a more robust appraisal remedy would only help and not hurt stockholders, we do agree that "[a]ppraisal can serve as an important safeguard in settings where executives of the target firm may have financial incentives (e.g., golden parachutes, and related M&A side payment) to sell the firm [at a price below fair value], potentially undermining the executive's bargaining power to negotiate on behalf of shareholders."[50] In such cases, where a conflict

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FIN. 579 (1986) (offering evidence that demand for publicly traded stocks is inversely related to price); A. Kaul et al, *Demand Curves for Stocks Do Slope Down: New Evidence from an Index Weights Adjustment*, 52 J. FIN. 893 (2000) (same).

[50] Amici Opening Brief at 13-14.

exists and the dissenters can prove that as a result of the conflict target management downwardly manipulated the pre-announcement market price, it may indeed be appropriate to doubt that the pre-announcement market price fully reflects fair value. This is precisely why a presumptive, pre-announcement market price ceiling on appraisal awards would not, as the Amici Opening Brief argues, render the appraisal remedy "a nullity."[51]

[51] Amici Opening Brief at 2.

CONCLUSION

For all the reasons set forth herein, *Amici* support the position advanced by Respondent-Below/Appellee and respectfully urge this Court to continue the salutary trend exemplified in *DFC* and *Dell*, which the Court of Chancery followed here, to shift away from expert appraisal valuations in favor of publicly available market values.

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Dated: November 20, 2018

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CERTIFICATE OF SERVICE

I hereby certify that on November 20, 2018, a copy of the Corrected Brief of Professors William J. Carney and Keith Sharfman as *Amici Curiae* in Support of Appellee and Affirmance was electronically served via *File & ServeXpress* upon the following:

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